

ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author: AR&T Committee Analyst: John Pavalasky Bill Number: AB 1115
Related Bills: See Legislative History Telephone: 845-4335 Introduced Date: February 23, 2001
Attorney: Patrick Kusiak Sponsor: Franchise Tax Board

SUBJECT: Nonresident Taxation

SUMMARY

This Franchise Tax Board-sponsored bill would make a comprehensive change in the manner that nonresidents and part-year residents are taxed. This bill would specify, for the first time, clear, definitive rules that would be applied consistently to all taxpayers for calculating loss carryovers, deferred deductions, and deferred income. It would also allow the alimony deduction and itemized deductions to nonresidents, thus making California law consistent with case law from the U.S. Supreme Court and resolve a potential federal constitutional issue.

PURPOSE OF THE BILL

By providing detailed rules in the statute that specify clear and definitive rules for complex calculations, it will enable taxpayers and tax professionals to understand the law and thus result in improved compliance. By allowing the alimony deduction to nonresidents, it would resolve a potential federal constitutional issue.

EFFECTIVE/OPERATIVE DATE

This bill, as a tax levy, would be effective immediately and would be operative for taxable years beginning on or after January 1, 2001.

POSITION

Support.

At its December 18, 2000, meeting, the Franchise Tax Board voted 2-0 to sponsor the language introduced in this legislation.

Board Position:

<u> X </u> S	<u> </u> NA	<u> </u> NP
<u> </u> SA	<u> </u> O	<u> </u> NAR
<u> </u> N	<u> </u> OUA	<u> </u> PENDING

Department Director

Date

Gerald H. Goldberg

03/26/01

ANALYSIS

FEDERAL/STATE LAW

Federal law contains rules for the taxation of persons who are not citizens of the United States that have income from sources within the United States. Those rules relating to "aliens" (whether resident or nonresident) are specifically made not applicable to California law. California rules are not based upon whether a person is a "citizen" of the United States or California, but instead are based upon the concept of "residency." In general, any person who is in this state for other than a temporary or transitory purpose is a "resident" of this state regardless of whether that person is a United States citizen. Once a person becomes a "resident" of California, they do not lose this status when temporarily absent from California. A "nonresident" is any person who is not a "resident."

A "resident" of California is taxable upon all their income, regardless of the source of that income. However, it is a fundamental principle of California income taxation that "nonresidents" of the state are subject to tax only upon their income from sources within California. Thus, California lacks jurisdiction to tax nonresidents on income from sources outside this state.

Beginning in 1982, California (and several other states, including New York) adopted a method whereby the amount of tax imposed on a nonresident or part-year resident of the taxing state is computed upon the total income of the individual, as if that individual were a resident of the taxing state for the entire year. The resulting amount of tax is prorated based upon the ratio of adjusted gross income (AGI) with a source in the taxing state over AGI from all sources. This method imposes a tax only upon income having a source in the taxing state and at the same tax rates that would apply to a resident of that taxing state.

Under the California Revenue and Taxation Code (R&TC), credits are allowed against the tax in their entirety when credits are conditioned upon the transaction occurring wholly within California. All other credits, except for the renters credit and the credit for tax paid to another state ("other state tax credit"), are prorated using the ratio of AGI with a California source over AGI from all sources. The renters credit and the other state tax credit have their own special rules.

California law currently provides that the deduction relating to alimony payments is not subtracted from California gross income by a nonresident or by a part-year resident during any portion of the year he or she was not a resident of this state.

In 1996, Section 114 of Title 4 of the United States Code was enacted to limit state income taxation, on a source basis, of pension income. California law, for 1996 and later years, specifically provides that gross income of a nonresident from sources within this state cannot include "qualified retirement income." The California section specifies that it applies only during the period that the provisions of Section 114 of Title 4 of the United States Code, relating to limitation on state income taxation of certain pension income, are effective.

1. Treatment of loss carryovers, deferred deductions and deferred income.

Since the 1982 change in California law, a number of issues have arisen with respect to the proper treatment of loss carryovers, deferred deductions, and deferred income for nonresidents as well as individuals moving into or out of California.

Where the transactions in prior years that created these tax items occurred when the individual was a nonresident, the question is how these items should be treated in the current taxable year for current-year residents, current-year nonresidents, and individuals who are part-year residents for the current year. Without specifying how the computations for these complex calculations are to be made, the statute is susceptible to more than one interpretation.

2. Allowance of deductions to nonresidents.

A. Alimony. In determining California-source income, current law does not allow a deduction for alimony payments made by either a nonresident or a part-year resident during the time they are a nonresident, even if paid to a California resident. This provision denying a deduction was first introduced in 1957. The justification for this rule appears to have been that because California does not tax nonresident taxpayers on alimony income, nonresidents should not be allowed an alimony deduction. Because alimony cannot be deducted while a nonresident, it would appear that this constitutes, under *Lunding*¹, an impermissible categorical denial of deductions to nonresidents. The effect of the current California law is identical to the New York statute that was at issue in *Lunding*. It appears that all viable arguments that could have been reasonably advanced to support the calculation required by this California statute were already presented to and rejected by the U.S. Supreme Court in *Lunding*. Thus, the existing California law that denies the alimony deduction to nonresidents may facially violate the Privileges and Immunities Clause of the Federal Constitution.

The California Constitution, however, prohibits an administrative agency from refusing to enforce a California statute on the grounds that it is unconstitutional, unless an appellate court has determined that such statute is unconstitutional. Unless the statute is amended, the department would be required to continue to enforce it unless an appellate court rules otherwise.

B. Itemized deductions. The method that California uses to determine the rate of tax to apply against California source income of nonresidents has been upheld by the Supreme Court in a New York case. This method imposes a tax only upon income having a source in California but at the same average tax rate that applies to a resident. California's method first calculates a tax on total taxable income (TI) computed as though the nonresident or part-year resident had been a resident of California. Next, this tax is multiplied by the ratio of California source AGI to total AGI from all sources. The total of this equation is the amount of a nonresident's or part-year resident's tax. The current mathematical formula is:

$$\text{Tax on Total TI} \times \frac{\text{California Source AGI}}{\text{Total AGI From All Sources}} = \text{Pro-rated Tax}$$

¹ *Lunding Et Ux. v. New York Appeals Tribunal et al.* (1998) 118 S.Ct. 766 (citations and internal quotation marks omitted). Although New York's nonresident alimony statute, New York Tax Law Section 631(b)(6), is worded differently than California's Revenue and Taxation Code Section 17302, the effect is identical. It is unclear whether in *Lunding* the petitioner computed his deduction by applying the ratio of New York to total business income or AGI, or if, in his situation, the ratio was the same. From a constitutional standpoint, however, it makes little difference exactly how the deduction is prorated so long as the method can be substantially justified and does not result in a categorical denial of the deduction to nonresidents.

The statute's use of the ratio of California source AGI to total AGI from all sources instead of the ratio of California source TI to total TI from all sources to prorate the tax on total TI has the appearance of not allowing itemized deductions to nonresidents. Because itemized deductions are not allowed within the current AGI ratio, it could be argued that this constitutes, under *Lunding*, an impermissible denial of deductions to nonresidents.²

THIS BILL

This bill would specify clear, definitive rules that would be applied consistently to all taxpayers to calculate loss carryovers, deferred deductions, and deferred income to compute the measure of income that the tax is based upon. Additional rules for nonresidents and part-year residents are specified for the calculation of the rate of tax to be applied to that tax base (California sourced income and deductions of the nonresident or part-year resident).

This bill would also allow the alimony deduction and itemized deductions to nonresidents. This change would make California law consistent with case law from the U.S. Supreme Court, thus resolving a potential federal constitutional issue.

1. Treatment of loss carryovers, deferred deductions, and deferred income.

(A) Specifies in R&TC Section 17041 that when computing the rate of tax to be applied to the tax base (California sourced income and deductions of the nonresident or part-year resident), the calculation of the rate would be made as if:

- the nonresident or part-year resident were a resident of this state for the taxable year; and
- as if the nonresident or part-year resident were a resident of this state for all prior taxable years for any carryover items, deferred income, suspended losses, or suspended deductions.

This means that nonresidents or part-year residents would calculate their tax rate by determining the tax on their entire taxable income in the same manner as residents would use, and then by dividing that tax by the income that the tax was calculated upon. That rate would then be applied to a base consisting of California sourced income and deductions.

(B) In order to ensure that residents compute their entire taxable income in that manner, this bill specifies in subdivisions (a) and (c) of R&TC Section 17041 that taxable income of a resident for the entire taxable year would be computed as if the resident were a resident of this state for the current taxable year and all prior taxable years for any carryover items, deferred income, suspended losses, or suspended deductions.

This means that in computing the taxable amount of pension distributions of a **current-year resident** who, in fact, had not been a resident in some or all of the preceding years, the current-year resident would make that calculation for the current year as if the current-year resident were a resident of this state for all prior taxable years.

² It should be noted, however, that the existing methodology indirectly allows a nonresident a portion of total itemized deductions because tax on total taxable income (AGI less itemized deductions) is prorated.

Thus, in the case of an Individual Retirement Account (IRA), basis adjustments for all prior years would be determined under California law. For example, if a deduction would have been denied under California law for any prior year, the taxpayer's basis in the IRA would be increased by that amount. Moreover, a nonresident coming into California would not receive a stepped-up basis for annual contributions and earnings thereon simply because the individual was a nonresident when the contributions were made. This would conform the rules for determining basis in an IRA to the rules for determining basis of other types of deferred compensation.

This bill retains the rule which prohibits California from taxing, on a "source" basis, the pension income of a person who is a nonresident when the payment is received. This is consistent with the federal enactment of the provisions of Section 114 of Title 4 of the United States Code, relating to limitation on state income taxation of certain pension income, that allows only the state of residence to impose a tax on this pension income. Thus, **no change** would be made by this bill to the taxation of IRA or pension income of a person who is a nonresident of California when the payment is received.

(C) Since these changes apply consistent rules in calculating the "tax on total taxable income" and the "amount of total taxable income" for all carryover items, deferred income, suspended losses, or suspended deductions, the language in current R&TC Section 17041 that addresses the NOL deduction in computing the "tax on total taxable income" and the "amount of total AGI" would be repealed by this bill.

The changes specified by this language would accomplish the following results:

- The NOL deduction allowed in computing the "taxable income of a nonresident or part-year resident" would no longer be limited by the amount of NOL allowed in computing the "amount of total taxable income" but would be a separate computation.
- Clarifies that the amount of passive activity losses (PALs) allowed in computing the "taxable income of a nonresident or part-year resident" would not be limited by the amounts used in computing the PAL allowed in computing the "amount of total taxable income" but would instead be a separate computation with respect to the PAL activities having a California source. In this calculation, the nonresident or part-year resident would be allowed the \$25,000 offset for rental real estate activities, subject to the phase-out rules. The suspension and release of a California-source PAL in computing the "amount of total taxable income" would be a separate computation and would not be limited by the amounts used in computing the PAL allowed in computing the "amount of total taxable income."
- Capital loss carryovers and capital loss limitations of nonresidents would no longer be limited to or recognized by reference to capital loss carryovers and capital loss limitations used in computing the "amount of total taxable income." Instead, such carryovers and limitations would be separate computations with respect to the capital losses having a California source and entering into the "taxable income of a nonresident or part-year resident." For example, the \$3,000 capital loss limitation would be applied to capital losses entering into the computation of the "taxable income of a nonresident or part-year resident" without regard to the amount allowed in computing the "amount of total taxable income."

- The character of gains or losses on the sale or exchange of an IRC Section 1231 item (property used in the trade or business or certain involuntary conversions) entering into the computation of the "taxable income of a nonresident or part-year resident" would be determined without regard to the character of gain or loss of that IRC Section 1231 item determined in computing the "amount of total taxable income."

2. Allowance of deductions to nonresidents.

This bill would allow the alimony deduction and itemized deductions to nonresidents consistent with the *Lunding* decision to resolve a potential federal constitutional issue.

(A) **Alimony.** This bill would amend R&TC Section 17302, that previously denied a nonresident the deduction for alimony paid, to reflect the *Lunding* decision. That section would provide that the deduction for alimony payments is **allowed** to a *nonresident* or part-year resident in the ratio of "California AGI" for the entire year, computed without regard to the alimony deduction, to "total AGI" for the entire year, computed without regard to the alimony deduction.

(B) **Itemized Deductions.** This bill would amend R&TC Section 17041 to utilize California source TI rather than California source AGI and total TI rather than total AGI. Under the bill, the mathematical formula would be:

$$\frac{\text{Tax on Total TI}}{\text{Total TI}} \times \text{California Source TI} = \text{Pro-rated Tax}$$

A necessary part of this change would be to **allow** itemized deductions in computing the California source TI. The Supreme Court in *Lunding* approved the use of a formula to prorate the total deductions to determine the appropriate amount to be deducted on a source basis. Consistent with that methodology, total itemized deductions under this bill would be prorated by the ratio of California source AGI to total AGI to determine the amount of California source itemized deductions allowed in arriving at California source TI.

In order to utilize California source TI rather than California source AGI and total TI rather than total AGI:

- The bill would add new R&TC Section 17304 to provide the rules for prorating itemized deductions allowed in computing "taxable income of a nonresident or part-year resident."
- The bill would add new R&TC Section 17305 to provide the rules for limiting the standard deduction allowed in computing "taxable income of a nonresident or part-year resident."
- The bill would define the term "taxable income of a nonresident or part-year resident" in subdivision (i) of R&TC Section 17041 and would specify that that calculation would be made by a nonresident solely by reference to gross income and deductions derived from sources within this state. In addition, with respect to part-year residents, this bill would specify that the term also includes all items of gross income and all deductions, regardless of source, for any part of the taxable year during that the taxpayer is a resident of this state.
- The bill would repeal R&TC Section 17303 as it would be unnecessary due to the revisions being made to subdivision (i) of R&TC Section 17041.

3. Technical and Conforming Changes. The bill would make the following changes to reflect the amendments being made to R&TC Section 17041 by this bill:

- Would add R&TC Section 17015.5 to provide a definition of "part-year resident."
- Would amend R&TC Section 17055, relating to credits allowed for nonresidents and part-year residents, to refer to the proper ratio under the changes to subdivision (i) of R&TC Section 17041.
- Would amend R&TC Section 17062, relating to the calculation of alternative minimum tax (AMT), to reflect the changes being made to the structure of R&TC Section 17041 to make the two sections consistent.
- Would add a definition of "California adjusted gross income" in new R&TC Section 17301.3 to allow cross-references to that term in other sections.
- Would add a definition of "total adjusted gross income" in new R&TC Section 17301.4 to allow cross-references to that term in other sections.
- Would add a definition of "total taxable income" in new R&TC Section 17301.5 to allow cross-references to that term in other sections.
- Would add R&TC Section 17306, relating to limitations based on "adjusted gross income," to provide that those limitations would be based on "California adjusted gross income" in the computation of the "taxable income of a nonresident or part-year resident" and not by the limitation used in computing the "total taxable income."
- Would add R&TC Section 17307, relating to California IRA and Keogh deductions of a nonresident, to provide that these deductions would be limited by compensation or earned income entering into the computation of the "taxable income of a nonresident or part-year resident" and not by the limitation used in computing the "total adjusted gross income."
- Would repeal R&TC Section 17310 to reflect the changes being made to subdivision (i) of R&TC Section 17041 that contains the rules for all carryover deductions and specifies rules relating to NOLs.
- Would repeal R&TC Section 17554 to reflect the changes being made to subdivisions (a) and (i) of R&TC Section 17041 that contains the rules for all carryover items.
- Would amend R&TC Section 17734 to rephrase the section to define what items of income and deductions a nonresident beneficiary of an estate or trust is required to include in the computation of "taxable income of a nonresident or part-year resident." Taxable income of a nonresident or part-year resident would include only items of income and deduction derived by the estate or trust from sources within this state.
- Would amend R&TC Sections 17854, 17951, 17952, 17952.5, 17953, 17954, and 17955 to rephrase each section to specify that these sections provide rules for the computation of "taxable income of a nonresident or part-year resident" under paragraph (1) of subdivision (i) of R&TC Section 17041.

IMPLEMENTATION CONSIDERATIONS

This bill would improve the department's administration of state tax law by eliminating a significant area of ambiguity. Some tax forms and instructions would require changing, but this could be accomplished during the normal annual update of forms and procedures.

LEGISLATIVE HISTORY

SB 1326 (Alquist, Stats. 1982, Ch. 327) changed the method that tax was imposed on nonresidents or part-year residents so that the tax upon income having a source in California would be taxed at the same tax rates that would apply to a resident with the same total income. AB 2380 (Hannigan, Stats. 1984, Ch. 938) enacted a provision to require that in computing a net operating loss, a taxpayer was

deemed to be a resident of California in all prior years. AB 31 & SB 169 (Klehs-Alquist, Stats. 1991, Ch. 117 & 474) enacted a definition of California AGI used in the determination of the proper tax rate at which the California source income of a nonresident is being taxed.

PROGRAM BACKGROUND

Prior to the change enacted in SB 1326 (Alquist, Stats. 1982, Ch. 327), the amount of tax imposed on a nonresident or part-year resident was computed without regard to total income. Due to California's use of a graduated rate structure applicable to individuals, this method resulted in unfairness by giving nonresidents and part-year residents the benefit of being taxed at lower overall effective rates than residents with similar total income. The unfairness of this method can best be demonstrated by considering the treatment of a salaried individual who is transferred by his employer from New York to California on July 1st. Assume this individual is a married taxpayer who files a joint return and has a salary of \$100,000 with no other income or deductions. If the taxpayer's income subject to tax is \$50,000 by New York and \$50,000 by California, the taxpayer would have a considerably lower total tax liability than if the taxpayer had lived in either New York or California for the entire year. The primary reason for this disparity is that both New York and California have graduated tax rate schedules. For example, the tax on \$100,000 AGI using California tax rates for 1999 would be \$5,914 while twice the tax on \$50,000 AGI would be \$3,216 (2 x \$1,608).

Federal Constitution

The United States Constitution, under what is known as the Privileges and Immunities Clause, provides that the citizens of each state are entitled to all the privileges and immunities of the citizens of all the states.

In 1998 the United States Supreme Court considered the application of this clause to the alimony deduction, as follows:

"...One right thereby secured is the right of a citizen of any State to remove to and carry on business in another without being subjected in property or person to taxes more onerous than the citizens of the latter State are subjected to."¹

In *Lunding*, the Supreme Court struck down a New York statute that denied nonresidents an alimony deduction in computing New York AGI. The court held that New York's categorical denial of the deduction to nonresidents violated the Privilege and Immunities clause of the Federal Constitution,³ stating that New York had not substantially justified its discriminatory treatment of nonresidents.

³ Although New York's nonresident alimony statute, New York Tax Law Section 631(b)(6), is worded differently than California's Revenue and Taxation Code Section 17302, the effect is identical.

In striking down the New York statute, the Court accepted the taxpayers' assertion that the deduction for alimony should be allowed in the same ratio that their business income was attributable to New York sources because the amount of alimony paid was related to the amount of the New York source salary earned by the taxpayer.⁴

OTHER STATES' INFORMATION

Florida has no comparable method of taxation of nonresidents of that state since it has no state tax on the income derived by individuals from sources in that state.

Illinois, Massachusetts, Michigan, Minnesota, and New York use a method of taxing nonresidents similar to the manner used in California. That is, those states use a method whereby the amount of tax imposed on a nonresident or part-year resident is computed upon the total income of the individual, as if that individual were a resident of the state for the entire year. The resulting amount of tax is prorated based upon the ratio of AGI with a taxing state source over AGI from all sources. This method imposes a tax only upon income having a source in the taxing state and at the same tax rates that would apply to a resident of the taxing state having the same total income.

Those states were examined due to similarities to California of those states' population and business activity.

FISCAL IMPACT

This bill may result in minor but indeterminable departmental savings.

ECONOMIC IMPACT

Relevant tax information pertaining to these nonresident tax issues is not available. In some cases, taxpayers would be advantaged under these changes and in other cases disadvantaged. To the extent confusion exists with respect to interpreting tax laws, taxpayers typically report in a manner that is most advantageous to them. With clear legislative direction as to the proper reporting and to the extent taxpayers comply, the consistent application of the rule presented in this bill may result in additional tax paid by nonresidents on a self-assessed basis beginning in the 2001-02 fiscal year.

SUPPORT/OPPOSITION

Support: Franchise Tax Board

Opposition: Unknown

⁴ It is unclear whether in *Lunding* the petitioner computed his deduction by applying the ratio of New York to total business income or AGI, or if, in his situation, the ratio was the same. From a constitutional standpoint, however, it makes little difference exactly how the deduction is prorated so long as the method can be substantially justified and does not result in a categorical denial of the deduction to nonresidents.

ARGUMENTS/POLICY CONCERNS

California law does not contain clear guidelines with respect to the tax treatment of the income and deductions of nonresidents and part-year residents. This bill would establish, for the first time, clear, definitive rules that would be applied consistently to all taxpayers. It would ease the administration of California's laws and improve compliance by California taxpayers.

Arguments Pro

Some taxpayers and their representatives will support these changes since they eliminate ambiguity in the law and will reduce audits, protests, and appeals.

1. This bill would resolve the issues relating to the taxation of nonresidents and part-year residents that have arisen since 1982 with respect to NOLs, PALs, and IRC Section 1231 items. Also, it is consistent with the fundamental constitutional limitation that California lacks jurisdiction to tax nonresidents on income from sources outside this state. It places all current-year residents on the same footing for the current year (regardless of the actual residency status of that current year resident in prior years). And, it recognizes that since 1996, federal law only allows states to impose a tax on residents of the state with respect to distributions of pension income.

2. This bill would also resolve a potential federal constitutional issue. By amending the statute to allow the alimony deduction to nonresidents, California law would no longer apparently facially violate the Privileges and Immunities Clause of the Federal Constitution. **The California Constitution, however,** prohibits an administrative agency from refusing to enforce a California statute on the grounds that it is unconstitutional, unless an appellate court has determined that such statute is unconstitutional. Unless the statute is amended, the department will be required to continue to enforce current law unless an appellate court rules otherwise.

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